

**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER: 03-0486**

**Income Tax**

**For Tax Years 1998 and 2000**

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**I. Tax Imposition—Corporate Income Tax**

**Authority:** IC 6-8.1-5-1(b); 45 IAC 15-5-3(b); P.L. 86-272 (15 U.S.C. Sec. 381); Meridian Mortgage Co., Inc. v. State, 395 N.E.2d 433 (Ind. App. 1979, Second District)

Taxpayer protests the imposition of corporate income taxes.

**II. Tax Administration—Penalties and Interest**

**Authority:** IC 6-8.1-10-1; 45 IAC 15-11-2; IC 6-3-4-4.1

Taxpayer protests the imposition of penalties and interest.

**STATEMENT OF FACTS**

Taxpayer is a subsidiary of Company X. Company M Manufacturing (hereinafter referred to as "Company M") is related to the taxpayer. Company M has Indiana manufacturing plants. More facts will be provided as needed below.

**I. Tax Imposition—Corporate Income Tax**

**DISCUSSION**

Before examining the taxpayer's protest, it should be noted that the *taxpayer* bears the burden of proof. IC 6-8.1-5-1(b) states in pertinent part:

The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made.

The Indiana Administrative Code also states “[t]he burden of proving that a proposed assessment is incorrect rests with the taxpayer...” 45 IAC 15-5-3(b).

The audit report states, in relevant part:

[Company M], a brother/sister corporation has several manufacturing plants in Indiana. [Taxpayer] instructs [Company M] to manufacture and ship to [taxpayer’s] customers in Indiana and elsewhere. All of [Company M’s] production is done for [taxpayer].

And further:

Sales by a non-resident [taxpayer] of goods manufactured and shipped to their customers in Indiana by a manufacturer in Indiana at their direction and control is subject to gross income tax at the low rate. The shipments to the Indiana customer are intra-state sales of products manufactured in Indiana and never leave the state.

Sales shipped from Indiana to customers in other states where the taxpayer is not subject to a net income tax are included in the sales numerator as “throwback” sales.

Taxpayer states as “facts” the following, quoted at length from its February 1, 2005, letter:

[Taxpayer] was a manufacturer of steel components, such as chassis and galvanized steel roofing for recreational vehicles and manufactured homes. On July 31, 1998, [taxpayer] formed a subsidiary, [Company M] and transferred all of its manufacturing operations and assets, both in Indiana and in several other states, to the new subsidiary, as well as all manufacturing employees. Subsequently on August 1, 1998, [Company M] became the manufacturer of steel components for recreational vehicles and, also, [taxpayer’s] supplier.

And further:

[Taxpayer] was registered with the Secretary of State to do business in Indiana in 1998 and 1999, but the state withdrew [taxpayer’s] registration on August 10, 2000.

In other correspondence the taxpayer lists the following as “facts”:

- [Taxpayer] does not own property or have employees in Indiana and is commercially domiciled in Kansas.
- [Company M] manufactures products for [taxpayer]. [Company M] is also allowed to manufacture for unrelated third parties.
- [Company M] drop-ships manufactured product to customers upon [taxpayer’s] request.
- [Company M] will provide an invoice to the third party customer, with instructions for the third party customer to pay [taxpayer].

- When the third party customer receives the manufactured goods, it can elect to accept or reject the goods; if it accepts, then title to the good transfers from [Company M] to [taxpayer] and then from [taxpayer] to the third party customer.
- Title, possession, and risk of loss to the goods remain with [Company M] until the goods are accepted by the third party customer.
- [Taxpayer] compensates [Company M], at a contractually negotiated price, for the product and delivery cost.
- [Taxpayer] pays [Company M] an amount less than the amount that [taxpayer] receives from the third party customer. The differential is retained by [taxpayer] as profit.

The taxpayer states, among other things, that it is not “subject to the Indiana Adjusted Gross Income Tax, the Supplemental Net Income Tax, nor the Gross Income Tax” because the taxpayer “does not have substantial nexus in Indiana.” The taxpayer also argues that “its activities in Indiana do not exceed the scope of protection offered by P.L. 86-272.” The taxpayer also states that taxpayer’s sales are not subject to “throwback.”

Taxpayer at times in its correspondence cites to non-binding and out-of-state cases. Cases cited by the taxpayer that are not directly germane to the issue or are not authority are not addressed in this Letter of Finding (nor will arguments emanating from such cases be addressed).

The real issue is whether or not the taxpayer has inventory in Indiana. In Letter of Finding (“L.O.F.”) 02-0321 the Department analyzed facts that are similar to the present taxpayer’s. The facts in that L.O.F. involved a California corporation with a wholly owned subsidiary in Indiana:

Subsidiary holds certain manufacturing and operating assets and properties. Subsidiary manufactures metal containers and component parts—as well as metal caps and closures—for Taxpayer and other unrelated third parties. Subsidiary does all of its manufacturing at four plants—all of which are located in Indiana.

When the manufacturing process is complete, Subsidiary stores its finished products either at its own plant or at a third-party warehouse until Subsidiary is instructed by its customer—in this case, Taxpayer—to drop ship its goods to the end purchaser—in this case—Taxpayer’s customers.

Further, the L.O.F. notes:

When Taxpayer’s customers receive the product, the customers have the right to accept or reject shipment. Until a shipment is accepted, Subsidiary retains the legal title to and bears the risk of loss for the products. When a purchaser accepts a shipment, the title for those products passes from Subsidiary to Taxpayer, and then from Taxpayer to its customer, the end purchaser. Each of these transactions occurs at the location of the end purchaser where the shipment is accepted.

And finally, the L.O.F. found:

Taxpayer contends that it has no physical presence in Indiana. However, when Taxpayer sells goods to its Indiana customers—despite the fact that Subsidiary retains title to the goods for nearly the entire time between the manufacture of the goods and its ultimate delivery—Taxpayer controls those goods and those goods are located in Indiana. That makes those goods inventory, thereby establishing a physical presence in Indiana.

In reaching that finding, the L.O.F. relied on Meridian Mortgage Co., Inc. v. State, 395 N.E.2d 433 (Ind. App. 1979, Second District), for an analysis of “ownership.” In that case the Court of Appeals stated:

The three indicia of ownership of personal property are *title; possession; and control*, which includes the right to sell, dispose of, or transfer.

Id. at 439. In analyzing the indicia, the Court of Appeals stated:

There is a considerable body of law to the effect that holding title alone does not necessarily confer ownership. The law of trust provides one analogy. The trustee has legal title to the property, but it is the beneficiary who is the equitable owner and who is entitled to the benefit and enjoyment of the property.

Id. at 440. The court noted another analogy, namely “[A] stockbroker who holds stock for his customer in his own name or in street name. Here again legal title does not indicate the true owner of the property.” Id. The court also said, “Ownership can not be conferred by a wave of a magic semantic wand. We look past the terms of the agreement to the actual transaction.” Id.

Regarding Meridian Mortgage, the taxpayer argues that (*Emphasis added*):

One indicia of ownership, by itself, however, is not sufficient to establish that a person owns property. Rather, the court determined that it is *necessary to meet at least two of the three indicia to evidence that the ownership exists*. Furthermore, two or more of the indicia of ownership must be met *contemporaneously* in order to demonstrate the evidence of ownership.

Taxpayer arrives at this conclusion without providing quotations from the case. That is, the taxpayer fails to cite the *specific* language in Meridian Mortgage that it relies on for the test that the taxpayer fashions from the case (taxpayer cites to a page number). Taxpayer also fails to cite the *specific* language about contemporaneousness that taxpayer believes exists. The Department is unable to discern language from the cited case that supports taxpayer’s proposition.

As the Department found in Letter of Finding 02-0321, the Department finds in the present case as well. The taxpayer had control of the parts (not to mention title, which the taxpayer calls “instantaneous title”). Thus the taxpayer had inventory in Indiana. Having inventory in Indiana constitutes nexus and it exceeds the protection of P.L. 86-272. It also should be noted that the sales start at an Indiana manufacturing location, and often end at an Indiana selling point, thus such property is not transferred in interstate commerce. With regards to any property that is sold

to customers in other states, the taxpayer failed to meet its burden regarding exclusion from its sales numerator.

Finally, the taxpayer makes an argument regarding the year 1998, stating that “the auditor failed to include a \$5,000 estimated payment made by another corporation in the consolidated report ... to offset the additional tax assessed.” The auditor noted that a copy of the check was requested, but never received.

### **FINDING**

Taxpayer’s protest is denied.

## **II. Tax Administration—Penalties and Interest**

### **DISCUSSION**

The Department issued proposed assessments and penalties and interest for the tax years in question. Taxpayer protests the imposition of penalty and interest. With regard to interest, the Department refers to IC 6-8.1-10-1, which states in relevant part (*Emphasis added*):

(a) If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on his return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

...

(e) The department *may not* waive the interest imposed under this section.

With regard to the negligence penalty, the Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer’s carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and

prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer was also assessed an underpayment penalty per IC 6-3-4-4.1. Taxpayer has not affirmatively established reasonable cause, as required by 45 IAC 15-11-2(c).

**FINDING**

Taxpayer's protest is denied.

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